

This PLR discusses sales tax issues raised by various aspects of a company's sales of steam. See 86 Ill. Adm. Code 130.1951. (This is a PLR).

December 19, 2002

Dear Xxxxx:

This Private Letter Ruling, issued pursuant to 2 Ill. Adm. Code 1200 (see enclosed), is in response to your letter of August 8, 2002. Review of your request for a Private Letter Ruling disclosed that all information described in paragraphs 1 through 8 of subsection (b) of the enclosed copy of Section 1200.110 appears to be contained in your request. This Private Letter Ruling will bind the Department only with respect to AAA for the issue or issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that neither AAA nor a related taxpayer is currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

In your letter, you have stated and made inquiry as follows:

The purpose of this letter is to request a Private Letter Ruling pursuant to 2 Ill. Admin. Code 1200.120 regarding the Illinois Retailers' Occupation Tax ('ROT') and use tax consequences of a proposed re-structuring of the business of AAA.

Facts

Company Profile

AAA owns a coal-burning electricity generating and fly ash producing plant in CITY, Illinois. The plant is located within the CCC Enterprise Zone. AAA received its charter from the State of Illinois on December 13, 1950. The company was organized for the purpose of constructing, owning, and operating electric power generating and transmission facilities to produce and supply electric power to a uranium processing plant located in CITY/STATE. The first generation of power by means of the facilities occurred on DATE. The plant began systematic manufacturing of fly ash for commercial use in DATE.

Today, approximately 20% of AAA's electric power is sold to the DDD and approximately 80% is sold to four electric utilities. These four electric utilities each own shares of AAA. They are known as 'the Sponsoring Companies' because they originally formed AAA and are the only shareholders of AAA.

A Description of Current Operations of AAA

As stated above, AAA owns and operates a coal-fired electricity generating and fly ash producing plant. The plant consists of six boiler and turbine units. The following is a brief description of how AAA's coal-fired plant works:

1. Coal is received at AAA's plant from either rail car or river barge and then conveyed to the crusher house. From the crusher house, the coal is either sent to the storage pile for future use or is sent through the primary coal crushers, where the coal is crushed to about 1 inch in size.
2. The coal is then conveyed from the primary coal crushers to one of the plant's thirty coal bunkers. From this point, coal is fed from the bunker into the pulverizer, where it is ground into a fine powder, similar in consistency to talcum powder. A large fan connected to the pulverizer blows the powdered coal into the combustion chamber of the boiler, where it burns at extremely high temperatures.
3. Each boiler is lined with tubes containing approximately 32,000 gallons of 'boiler feedwater' (purified, treated, and demineralized water), which is pumped from the water treatment plant. The water used in the boiler system must be of high quality to prevent scaling inside the boiler tubing and plating of silica on the turbine blades.
4. The intense heat from the coal burning process transforms the boiler feed water in the boiler furnace tubes into saturated steam. Each boiler unit produces approximately 1,250,000 pounds of high-pressure steam per hour. The high-pressure steam is further heated to 1050 F and piped to the high-pressure section of the turbine. Shortly before the steam enters the turbine, it passes through a stop valve. This steam, after passing through the high-pressure turbine, is returned to the boiler where it is reheated to 1000 F and piped to the intermediate-pressure section of the turbine. At this point, the steam expands through the intermediate section and then to the low-pressure sections of the turbine.
5. The turbine resembles a massive drum with thousands of propeller blades and is directly coupled to a generator rotor. The steam hits the turbine blades causing the turbine/generator to rotate, creating electricity at 20,000 volts. The voltage is then increased by transformers to 161,000 volts for transmission to the electric system.
6. Low-pressure steam is still warm and pressurized. The low-pressure steam exits the turbine and passes over water-cooled tubes where it is condensed back into water. This condensate (boiler feedwater) can be circulated back into the boiler system, where it starts the steam cycle again. The boiler feedwater leaves the condenser through pipes that will circulate the water to the boiler. At the boiler, the water will be heated and turned into high-pressure steam. Due to the continual loss of steam during the electric generation process, boiler feedwater is constantly being added to the system. Water loss is generally in the range of 2,000,000 to 4,000,000 gallons per month for the plant.
7. AAA has received certification for the period of January 10, 2002 through January 9, 2007 from the Illinois Department of Commerce and Community Affairs (DCCA) as being eligible to receive the Enterprise Zone Expanded

Manufacturing Machinery and Equipment exemption. A copy of the certification is attached hereto and fully incorporated by reference.

A Description of Current Subsidiary Operation of AAA.

In addition to its activities generating electricity and producing fly ash, AAA also has four wholly owned operating subsidiaries. Each subsidiary has a specific operational function, as described as follows:

1. GGG. This subsidiary allows AAA to achieve low transportation costs for its fuel. GGG transports coal from mines in the western U.S. to the plant. GGG's assets include rail cars.
2. XYZ. This subsidiary owns and operates gas-fired combustion turbines. XYZ sells this electricity to the Sponsoring Companies during the peak summer months, when demand for electricity is high. XYZ's assets include gas-fired turbines and some transmission lines.
3. JJJ. This subsidiary sells all of AAA's ash products to be used in an environmentally acceptable manner. The coal that AAA purchases produces a distinct and highly marketable product from the coal combustion process called 'Type C' fly ash. JJJ primarily sells this state-certified Type C fly ash to HHH for use as an ingredient in concrete. JJJ's assets include fly ash inventory and related storage. JJJ is registered as a reseller with the Illinois Department of Revenue.
4. UUU. This subsidiary purchases materials and resells them to affiliated companies and unrelated third parties. UUU's assets include office computers and office furniture. UUU is registered as a retailer with the Illinois Department of Revenue.

Each subsidiary observes corporate formalities and transacts business with affiliates and unrelated third parties at arms-length. For example, UUU issues resale certificates to its vendors and either collects Illinois ROT from its affiliates and unrelated third parties, when applicable, or properly documents an exemption, when applicable. UUU also processes and retains commercial documentation, such as purchase orders and invoices, from both affiliates and unrelated third parties.

Proposed New Subsidiary (ZZZ)

This request for private letter ruling is focused on the Illinois ROT and use tax consequences of repositioning the generation of electricity and boiler feedwater from AAA into another newly created subsidiary, hereafter referred to in this letter as 'ZZZ'.

ZZZ would be created by AAA's contribution of its turbines, generators, condensers, feedwater heaters, river cooling water systems, water treatment plant systems, and related assets. ZZZ would produce and sell three different products or commodities. These are electricity, boiler feedwater, and low-pressure steam. Like the existing four subsidiaries of AAA, ZZZ would be completely integrated in its operations with its parent company, AAA, and with the other subsidiaries of AAA.

Under the proposed business structure, AAA, the parent company, would purchase coal from unrelated suppliers in order to operate its boilers for the purpose of manufacturing high-pressure steam and Type C fly ash. AAA would then sell at retail the high-pressure steam at the turbine stop valve to its subsidiary ZZZ and sell Type C and other ash products to JJJ. ZZZ would own the re-heating system that circulates intermediate pressure steam back through the boilers owned by AAA. The re-heating system intermediate pressure piping is separate from the high-pressure piping, which would be owned by AAA up to the turbine stop valve. ZZZ will utilize the high-pressure steam to operate its turbines/generators to produce electricity. ZZZ will then sell the resulting electricity to AAA's sponsoring companies and to the U .S. Government. ZZZ could then choose to sell low-pressure steam to AAA or to other potential local customers. Potential local customers could include a cement manufacturer, chemical manufacturer, a gas pipeline company, agricultural greenhouse, and local schools. ZZZ would sell the condensate/boiler feedwater to AAA and to its affiliate XYZ through a permanent pipeline connection already in place. AAA would sell the Type C and other ash from its steam manufacturing process to its subsidiary JJJ, which would then resell the ash to HHH for use by various customers including concrete manufacturers.

In creating ZZZ as a new subsidiary, AAA would be separating electricity generation/transmission and sales and the production/manufacturing of boiler feedwater on the one hand from the manufacturing and sales of steam and Type C fly ash and other ash products on the other. This is because the manufacturing of steam and Type C fly ash would be retained in AAA, the parent company. This is consistent with the philosophy that is embodied in the four existing subsidiaries of AAA. That philosophy is to minimize the risk of loss from operations that are contained in subsidiary companies by isolating them in separate legal entities. This is especially important in the case of electricity generating and transmission, which is the largest activity that would be performed in ZZZ, and in the case of the manufacturing and sales of steam both of which are generally risky activities.

Under the proposed new business structure, ZZZ and AAA would have permanently connected physical facilities, as would ZZZ and XYZ. The piping from the AAA boilers up to the turbine main steam stop valves would be owned by AAA, but ZZZ would own the stop valves and connecting piping to the turbine. Similarly, piping from ZZZ's condensers and feedwater heaters to AAA's boilers would be owned by AAA. Likewise, piping from ZZZ's condensers and feedwater heaters to XYZ would be owned by XYZ. The water treatment plant owned by ZZZ would supply boiler feedwater to the condensers for feedwater make-up, and also sell boiler feedwater to both AAA and XYZ.

Issues

Before committing to the formation of ZZZ, AAA would like to make sure that it has authoritative answers on which it can rely to the following questions concerning the Illinois ROT and use tax treatment of the transactions in which ZZZ would be involved. These are as follows:

1. Will AAA, the seller of high-pressure steam, be responsible for collecting and remitting Illinois ROT on the sale of steam to ZZZ?

2. Will the sale of boiler feedwater and condensate by ZZZ to AAA, the steam manufacturer, qualify as a nontaxable sale for resale?
3. Will the fuel purchased by AAA to manufacture the steam qualify under 35 ILCS 120/1d for the Expanded Enterprise Zone Act Manufacturing Machinery and Equipment Exemption available to businesses certified by DCCA?

Conclusions

Our conclusions on these three Illinois ROT and use tax issues, based on the analyses given below, are as follows:

1. AAA would be responsible for collecting and remitting Illinois ROT on the sale of high-pressure steam to ZZZ.
2. ZZZ's sale of boiler feedwater and condensate to AAA would be exempt from Illinois ROT as a sale for resale.
3. AAA has received certification by DCCA as meeting the requirements of an enterprise zone manufacturer entitled to the Expanded Manufacturing Machinery and Equipment Exemption. Therefore, the fuel that AAA purchases to manufacture the high-pressure steam and Type C fly ash would qualify for exemption under the Expanded Enterprise Zone Act Manufacturing Machinery and Equipment Exemption.

Analysis

Our analysis of these issues is as follows:

Issue One: ROT on Sale of High-Pressure Steam by AAA to ZZZ

According to the applicable Department of Revenue regulation, 86 Ill. Admin. Code 130.2156, Vendors of Steam, it appears that the seller will be responsible to collect and remit ROT on the sale of steam to its customers.

The regulation states '[p]ersons who engage in the business of selling steam to purchasers for use or consumption and not for resale, incur Retailers' Occupation Tax liability on their receipts from such sales.' 86 Ill. Admin. Code 130.2156(a). The regulation also states that '[p]ersons who are engaged in the business of transferring heat energy to purchasers using steam as the vehicle for that transfer, do not incur Retailers' Occupation Tax liability so long as no tangible personal property is transferred to the purchaser. This would be the case, for example, where the condensate, which results when the steam loses its heat, is returned to the seller.' 86 Ill. Admin. Code 130.2156(b). Put another way, there is no ROT liability where the condensate is returned to the seller at no cost.

Under the proposed new structure, AAA would manufacture steam and sell it to its wholly owned subsidiary, ZZZ. This transaction would occur pursuant to a contract between AAA and ZZZ for the sale of steam at fair market value. The procedures under the contract would include ZZZ issuing purchase orders to AAA for steam and AAA invoicing ZZZ. The contract would provide that title to the steam would pass from AAA

to ZZZ at the stop valve, which is owned by ZZZ and positioned in the system directly in front of ZZZ's turbine.

This contract for the sale of steam would not require ZZZ to return the condensate that results from the cooling of steam to AAA. Moreover, it is a fact that some of the boiler feedwater and condensate will be sold by ZZZ to its affiliate, XYZ, and that other buyers for the condensate have been identified.

It is contemplated that AAA and XYZ, though not obligated to do so, would purchase a large percentage of the available condensate from ZZZ and that ZZZ though not obligated to do so, would sell a large percentage of the available condensate to AAA and XYZ. These transactions in condensate would be the subject of separate contracts between ZZZ and AAA and ZZZ and XYZ.

Based on the regulation quoted above (86 Ill. Adm. Code Section 130.2156), it appears that AAA would be responsible for collecting ROT on the price of the steam that it sells to ZZZ and other potential customers, because the steam will be sold at retail (and not for resale) to purchasers for use or consumption. The exemption from ROT that is described in subsection (b) of the regulation would not apply, because under the contract between AAA and ZZZ for the sale/purchase of steam, there is no obligation on ZZZ to return condensate to AAA. The condensate that would in fact flow from ZZZ to AAA and XYZ would do so pursuant to a separate contract for the sale/purchase of the condensate at a fair arm's length price.

Issue Two: Sale for Resale Exemption for ZZZ's Sale of Boiler Feedwater and Condensate to AAA

Under the proposed new structure, after the steam has passed through ZZZ's turbine it would be directed into a condenser that is owned and operated by ZZZ. In the condenser, the steam would be cooled to produce condensate (boiler feedwater).

As described in the discussion of Issue One, ZZZ would sell the condensate to AAA and XYZ and potentially to other buyers. The sale of boiler feedwater both to AAA and XYZ, would be under duly executed contracts that would set the price for the boiler feedwater at an appropriate market level, notwithstanding that the buyers (AAA and XYZ) are related to the seller ZZZ. Under the terms of the boiler feedwater sales contracts, title would pass from ZZZ when the condensate and boiler feedwater make-up water exits from the condenser and enters pipes that are owned by AAA and would take it to the AAA boiler or from the water treatment plant to XYZ's facility through piping owned by XYZ, as the case may be. All parties (AAA, XYZ, and ZZZ) would observe the formalities of a commercial transaction, including issuing and approving purchase orders and invoices and, where appropriate, resale certificates.

Under the proposed new structure, AAA would be acquiring the boiler feedwater as a tangible ingredient for its steam manufacturing business. At its boiler, AAA would use a heating process to turn the boiler feedwater into steam.

Since AAA would be using the boiler feedwater as an ingredient in the manufacturing of steam, which, as described in Issue One, would then be sold at retail to ZZZ, the sale of condensate and boiler feedwater used, as make-up from ZZZ to AAA should qualify as a sale for resale.

Facts have not been provided in this request for private letter ruling concerning the use of the boiler feedwater by XYZ, and accordingly the treatment of the sale of boiler feedwater by ZZZ to XYZ is not an issue for which a ruling is being requested.

Issue Three: ROT and Use Tax Exemption for Fuel Purchased by AAA as a Certified Enterprise Zone Manufacturer

AAA has received certification from the Illinois Department of Commerce and Community Affairs ('DCCA') that it has met the requirements to be entitled to claim the expanded Manufacturing Machinery and Equipment Exemption.

According to the applicable statute, 35 ILCS 120/1d, the use or consumption of tangible personal property by a manufacturer located within an enterprise zone and certified by DCCA is not taxable. Under the Department's regulation, 'any fuel, such as coal, diesel oil, gasoline, natural gas, artificial gas or steam which would be subject to Retailers' Occupation Tax or Use Tax liability when sold at retail is exempt from those taxes when sold for use as fuel for machinery and equipment which qualifies for the manufacturing machinery and equipment exemption as set out in 130.330 [Manufacturing Machinery and Equipment].' 86 Ill. Admin. Code 130.1951(b)(5)(f).

The Department has acknowledged in a general information letter that if a producer of steam sells steam at retail and transfers the condensate to the customer, then the steam producer can qualify for the expanded manufacturing machinery and equipment exemption. Illinois Department of Revenue Letter Ruling No. St-97-0268-GIL, May 15, 1997. AAA has been certified by DCCA as an enterprise zone manufacturer and the primary purpose of its assets will be to manufacture high-pressure steam and Type C fly ash for sale at retail to ZZZ and to JJJ respectively. Therefore, under the applicable statute and the Department's regulation, the fuel used and consumed by AAA, as a DCCA certified business, in the high-pressure steam and Type C fly ash manufacturing process should qualify for the expanded manufacturing machinery and equipment exemption.

Summary

The execution of the restructuring described in this letter would entail significant costs for AAA. Accordingly, AAA is desirous of obtaining a private letter ruling on which it can rely from the Illinois Department of Revenue confirming its conclusions on the Illinois ROT and use tax issues discussed herein. AAA has appointed FIRM to prepare this private letter-ruling request and to discuss the issues raised herein with any personnel designated by the Illinois Department of Revenue. The power of attorney formalizing that appointment is attached.

Please feel free to contact # with any questions or comments you may have. AAA would request that no negative ruling be issued on any issues raised in this letter without prior discussion of the issue(s) between the Department and AAA or its representatives. If the Department is in agreement with the analysis and conclusions presented in this private letter ruling request, we would request that the Department issue the private letter ruling with copies to both AAA and FIRM.

Based upon the information presented, the Department's position in regard to the questions is as follows:

In regard to question one, the Department agrees that AAA would be responsible for collecting and remitting Illinois ROT on retail sales of high-pressure steam to ZZZ. This is because the Department considers steam to be sold at retail and subject to tax when the steam is sold and the condensate is transferred. Persons who are engaged in the business of selling steam to purchasers for use or consumption and not for resale incur Retailers' Occupation Tax liability on their receipts from such sales. See 86 Ill. Adm. Code 130.2156 regarding vendors of steam. However, you have indicated that at least some portion of the material that is sold as steam is not "used" or "consumed." This steam eventually cools and becomes condensate. The condensate is then "resold." When this is the case, it is the Department's position that only the steam that is "used" or "consumed" will be subject to sales tax. The portion of the steam that cools and becomes condensate that can be "resold" by ZZZ would not be subject to sales tax when sold by AAA. However, when ZZZ sells the condensate at retail, Retailers' Occupation Tax will be due.

In regard to question two, the Department agrees that ZZZ's sale of boiler feedwater and condensate to AAA is exempt from Illinois ROT as a sale for resale, so long as the sale for resale is properly documented.

In regard to question three, the Department agrees that since AAA has received certification by DCCA as meeting the requirements of an enterprise zone manufacturer entitled to the Expanded Manufacturing Machinery and Equipment exemption, AAA may purchase the fuel that it uses to manufacture the high-pressure steam and Type C fly ash free of sales tax.

The facts upon which this ruling are based are subject to review by the Department during the course of any audit, investigation, or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

I hope this information is helpful. If you have further questions related to the Illinois sales tax laws, please contact the Department's Taxpayer Information Division at (217) 782-3336.

Very truly yours,

Martha P. Mote
Associate Counsel

MPM:msk
Enc.